NEW YORK STATE BAR ASSOCIATION TAX SECTION

REPORT ON FINAL DUAL CONSOLIDATED LOSS REGULATIONS

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NEW YORK STATE BAR ASSOCIATION TAX SECTION

REPORT ON FINAL DUAL CONSOLIDATED LOSS REGULATIONS

I. INTRODUCTION AND RECOMMENDATION SUMMARY[1]

On March 19, 2007 the Internal Revenue Service and the Treasury Department (hereinafter referred to collectively, as the "Treasury") released the final dual consolidated loss regulations (the "Final Regulations") under Section 1503(d) of the Internal Revenue Code of 1986, as amended (hereinafter, the "Code").[2] These regulations finalize, with changes, the proposed revisions to the dual consolidated loss regulations announced on May 24, 2005 (the "Proposed Regulations"),[3] which were the subject of our Report No. 1100 (December 21, 2005) (the "2005 NYSBA Report").

Generally, the dual consolidated loss ("DCL") rules restrict certain forms of international transactions producing a double tax benefit from a single economic event, or double-dipping ("double-dip"). In broad terms, the DCL limitations of Section 1503(d) prevent any dual resident corporation or unit from using a loss to offset the U.S. income of another U.S. person (e.g., a consolidated group member or another "domestic affiliate" as defined in the Final

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1 The principal author of this report was David R. Hardy with substantial assistance from Paul Seraganian, Patrick Gallagher and Peter Connors. Helpful comments were received from Michael Schler, Andrew Braiterman, Diana Wollman, Yaron Reich, Andrew Chalnick and Peter Blessing.

2 T.D. 9315, 2007-15 IRB 891, subsequently amended by Announcement 2007-49, 2007-21 IRB 1300 (May 17, 2007). Unless otherwise specified, all "Section" references are to the Code.

3 Notice of Proposed Rulemaking 102144-04, 70 Fed. Reg. 29868.

Regulations) and simultaneously using the loss to offset the income of a foreign person ("foreign affiliate") for tax purposes. Any such DCL will be subjected to separate return limitation year[4] ("SRLY") type limitation so that the DCL can only be used to offset the income of the entity or unit generating such loss. Where such dual use of a loss is possible, a taxpayer may elect to use the loss to offset the income of a domestic affiliate ("domestic use election") provided it formally agrees that a subsequent use, within a prescribed period, of any of the loss for foreign income tax purposes by a foreign person (other than the person or unit that generated such loss) will result in the full recapture of the loss for U.S. tax purposes.

The Proposed and Final Regulations were designed to address certain under-inclusions and over-inclusions of the prior rules[5] contained in the regulations previously in effect (the "1992 DCL Regulations").[6] Some have asserted that the DCL rules and their associated legislative history have never articulated a sufficiently coherent policy objective to allow one to ascertain clearly what constitutes under-inclusion or over-inclusion.[7] The Final Regulations do not fill this gap. However, the Final Regulations have made a number of important simplifications and clarifications to the DCL provisions. In particular, the Final Regulations simplify the domestic

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4 See Treasury Regulation § 1.1502-21(c).

5 See the Preamble ("Preamble") to Final Regulations accompanying T.D. 9315.

6 T.D. 8434 1992-2 CB 240 (Sept. 9, 1992), as subsequently amended.

7 The original legislative history indicated that Section 1503(d) was designed to prevent dual resident foreign acquirers from having a competitive advantage over U.S. acquirers. See S. Rep. No. 99-313, 1986-3 C.B. Vol. 3 at 420. This purpose was supplanted by the prohibition of outbound double-dips following the 1988 statutory changes to 1503(d) and the check-the-box regulations. Some detractors argue that, the U.S. deduction being otherwise available, a double dip against foreign tax increases residual profits of the U.S. taxpayer and decreases foreign tax credits upon repatriation to the U.S., thus providing a long term benefit in the collection of U.S. tax. Perhaps the most convincing policy defense of Section 1503(d) as it pertains to U.S. multinationals is the economic theory of capital export neutrality. Double dips are said to violate capital export neutrality since they are unintended tax consequences that encourage U.S. taxpayers to make investments outside the U.S. rather than domestic investments.

use election and reduce the impact of domestic use recapture by substantially shortening the period for which taxpayers are required to certify the absence of foreign use to five years (down from fifteen years under the 1992 DCL Regulations). Among the other significant changes in the Final Regulations are: (i) elimination of the special basis adjustments of prior law;[8] (ii) the broadening of the separate unit combination rule; (iii) the provision of foreign-use safe harbors; (iv) the adoption of clarifying rules regarding transparent entities; and (v) the clarification that the DCL limitations do not restrict foreign taxes for which the taxpayer elects to use a credit under Section 901.

The Final Regulations also narrowed the scope of the DCL limitations through their changes to the treatment of transparent entities. In the Proposed Regulations, Treasury noted that natural partnerships are likely to be transparent in a foreign country and therefore are not likely to be used for double-dip transactions. By contrast, a foreign entity that is treated as a corporation for foreign tax purposes but that is fiscally transparent for U.S. tax purposes is ideally suited for facilitating dual utilization of deductions.[9] The Final Regulations adopt the definitional changes of the Proposed Regulations. Correspondingly, the Final Regulations generally exclude the items of natural partnerships from the operation of the DCL rules and provide a framework for addressing the items of such natural partnerships, including (i) a

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8 Final Regulation §1.1503(d)-5(g). The 1992 DCL Regulations reversed the normal consolidated return stock basis adjustment rules to prevent a disallowed DCL loss from resurfacing as a capital loss, which was not subject to the DCL limitations.

9 Because the dual consolidated loss rules do not apply to domestic units of foreign corporations, the definition of "hybrid entity" for purposes of the Final Regulations does not include a domestic reverse hybrid entity that is treated as a corporation for U.S. tax purposes but as a partnership for foreign tax purposes. See Final Regulations §1.1503(d)-1(b)(3) and (16). See also Preamble at ¶¶ D and E. Also, the definition excludes a foreign reverse hybrid entity (i.e., a foreign entity treated as a corporation for U.S. tax purposes but as a partnership for foreign tax purposes), since under U.S. tax law its losses are not available to a domestic affiliate.

definition of "transparent entity," (ii) attribution rules for such transparent entities, (iii) the exclusion of transparent entity items from DCL calculations, and (iv) treating an interest in a transparent entity as a domestic affiliate.

The most significant of the suggestions of the 2005 NYSBA Report not accepted by the Treasury in the Final Regulations was the suggestion to eliminate the all or nothing rule for domestic use election recapture.[10] The all or nothing rule provides that the foreign use of any amount of a DCL subject to a domestic use election will result in a recapture of the entire loss previously claimed in the U.S. This rule can result in a forfeiture where insignificant amounts of a DCL are used to offset foreign income and that minimal foreign use triggers full recapture in the U.S. Through the operation of the all or nothing rule, it is possible that all or a significant part of a taxpayer's genuine economic loss may never be deductible in any jurisdiction. The potential for similar forfeiture exists under the mirror legislation rule described below.

The DCL rules are designed to identify losses that can be double dipped. For this purpose, the rules have always adopted the important simplifying mechanic that the "loss" component of a DCL is calculated under U.S. principles of Section 172.[11] However, because the DCL rules also depend upon the application of foreign tax laws to U.S. taxpayers (for instance, for the purpose of detecting whether there has been a "foreign use" of a dual consolidated loss),

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[10] The Preamble commented that the reduction to a five-year certification period substantially reduces the compliance burden of a domestic use election and may justify Treasury's decision to retain the all of nothing recapture rule.

[11] See 1992 DCL Regulation §1.1503-2(c)(5) and Final Regulation § 1.1503(d)-1(b)(5). Some might argue that, because the statute uses the term "net operating loss of a domestic corporation," the DCL rules are required to look to the existence of a loss calculated under Section 172. However, the statute further states in Section 1503(d)(2)(B) that: "to the extent provided in regulations, the term 'dual consolidated loss' shall not include any loss which, under the foreign income tax law, does not offset the income of any foreign corporation." Thus some latitude exists.

continual choice-of-law questions arise. The inherent complexities from the choice-of-law questions, inter alia, make the determination of whether there has been an offending foreign use of a DCL a challenging task, and inconsistencies in application inevitably arise. In this context, the forfeiture impact of certain of the DCL rules is harsh. Accordingly, many of our comments regarding the Final Regulations, as well as our responses to particular requests for comments by the Treasury, seek to promote the ability of taxpayers to avoid or mitigate such forfeitures through specific applications to the IRS under procedures like those already utilized for other purposes in the Final Regulations.

This report is divided into two sections below. The first section (part II below) describes Treasury's major decisions in the Final Regulations that, in our view, may warrant further consideration or development. The second section (part III below) responds to certain of Treasury's specific requests in the Preamble for further comments on particular issues that have not been addressed in our recommendations.

The principal recommendations of this report are summarized below:

1. The All or Nothing Rule. Currently, the recapture of a DCL as a result of foreign use of such DCL relates to the entire loss, even if only a small amount of loss is used in a foreign jurisdiction. This can cause the taxpayer to forfeit the deduction of genuine economic costs. We suggest that the Treasury, while retaining the all or nothing rule as the default rule, consider adopting an additional rebuttal procedure allowing the taxpayer to establish, to the satisfaction of the Commissioner, the portion of the DCL actually utilized to offset the income of a foreign person. In such event, the recapture amount would be limited to the portion of the DCL that was actually used to offset the income of a foreign person.

2. Mirror Legislation – Expand Elective Agreements. The mirror legislation rule can also result in taxpayer forfeitures, because losses of entities subject to reciprocal mirror legislation are not deductible anywhere. The Mutual Agreement entered into on October 6, 2006 by the Competent Authorities of the U.S. and the United Kingdom (the "US/UK Agreement")[12] provides flexible procedures whereby a taxpayer may elect to use losses in either jurisdiction but not in both. As applied to our best Treaty partners with strong audit procedures and information sharing mechanics, agreements like the US/UK Agreement may operate in a manner similar to a domestic use election. In our view, arrangements similar to the US/UK Agreement are the answer to the simplification of DCL compliance and avoidance of many DCL risks. Naturally, the US/UK Agreement is applicable with respect to only one foreign country and only a limited scope of transactions invoking the U.K. mirror legislation. We recommend expanding the US/UK Agreement to apply not just to the limited mirror legislation situations but to all US/UK DCL transactions as a general elective agreement under Final Regulation §1.1503(d)- 6(b). We also recommend that this become the model for use in all United States tax treaties.

3. Reduction of Recapture Amount – SRLY. We recommend that taxpayers be permitted to reduce DCL recapture by the amount of income the dual resident unit subsequently generated on a stand-alone basis (without reductions for years when the U.S. consolidated group had losses as prescribed under SRLY).

4. Indirect Foreign Use. The concept of indirect foreign use can inappropriately broaden the recapture events for domestic use elections. As written, indirect foreign use can be presumptively established by the existence of inconsistent treatment of items

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[12] See Announcement 2006-86, 2006-45 IRB 842.

by the U.S. and the relevant foreign jurisdiction if the items have the effect of moving to a foreign person an item of loss composing the DCL. Because the DCL rules apply U.S. tax law principles to units operating in foreign countries, inconsistencies are to be anticipated and many of these inconsistencies may have the prohibited "effect" described above, some intended, others not. We believe this is an inappropriate test for recapture because it relies heavily on foreign law, has an uncertain scope, and will encompass routine non-abusive transactions. Accordingly, we suggest that safe harbors be provided for "indirect foreign use".

5. Consistent Attribution of Items. We recommend that the methodology for the attribution of items to separate units in the Final Regulations be made consistent as to both natural branches and hybrid units. We believe that the Section 987 principles, adopted in Final Regulations §1.1503(d)-5(c)(3), of attributing items to hybrid units in accordance with local books and records, as adjusted for U.S. principles, is appropriate under the DCL rules, and we suggest that the same methodology be required for attributing items to natural branches. In both cases, in contrast to Final Regulation §1.1503(d)-5(c)(2)(ii), interest expense of the separate unit's Parent would not be attributed to the natural branch or hybrid unit under the principles of Treasury Regulation §1.882-5, except to the extent that, in accordance with Final Regulation §1.1503(d)-5(c)(2)(iii), local law looks beyond the branch books and records and attributes interest expense on another method.

6. Example 23 Reversed. We found it inexplicable that a Parent's loan to its foreign hybrid entity separate unit, as illustrated in Example 23 of the Final Regulations, does not create regarded interest expense and a DCL when the same loan by Parent to its natural branch would create a DCL because of Treasury Regulation §1.882-5 attribution. Our recommendation (see 5 above) for consistent attribution methods may eliminate the electivity of

this result. However, we believe that disregarding items of hybrid entity separate units when such items are regarded under local law and the local books and records is a problem and fails to properly identify the double dip opportunities.

II. SPECIFIC CHANGES IN FINAL DCL REGULATIONS

A. All or Nothing Rule

If a dual resident corporation or unit incurs a loss calculated under U.S. tax rules, that loss is subjected to SRLY limitations imposed by the DCL provisions.[13] Nonetheless, provided that there has been no foreign use of such loss, the dual resident corporation may still use the loss against the income of a domestic affiliate in the U.S. by making a domestic use election. Consistent with the 1992 DCL Regulations, the Final Regulations require a taxpayer who files a domestic use election to certify during a prescribed period (the "Certification Period") that the loss will not be used to offset the income of a foreign person. Under the Final Regulations, the Certification Period is now 5 years, down from 15 years under the 1992 DCL Regulations. The taxpayer must recapture the DCL subject to the domestic use election as recognized income in the U.S. (with an interest charge) if any portion of such loss is later utilized during the Certification Period to offset the income of a foreign person. The recapture of domestically utilized loss applies to the entire amount of the DCL for such year whether or not the full amount of such DCL was utilized for foreign tax purposes (the "all or nothing rule").

The Treasury received many comments suggesting that this all or nothing rule be liberalized. Some commented that the recapture should be limited to the amount of the loss actually utilized to offset foreign income. It was suggested that the amount of such foreign use

[13] See generally, Final Regulation §1.1503(d)-4.

could be demonstrated by certified copies of filed foreign income tax returns. Others suggested that no recapture should exist until some *de minimis* threshold is exceeded (for example, 15 percent of the DCL). The Final Regulations retain the all or nothing rule with no change,[14] stating in the Preamble that to do otherwise would create "substantial administrative complexity."[15] However, the Preamble also states that the scope of application of the all or nothing rule will be reduced as a result of the reduced Certification Period and the new exclusions to foreign use discussed below.

While we agree that the application of domestic use recapture may be reduced as a result of the measures described above, we continue to believe that the all or nothing recapture rule can produce severe results. In particular, because the existence of the loss composing the DCL is determined under U.S. tax rules, the deduction creating the DCL may not even be permitted under foreign law (e.g., where the loss relates to participation exempt income or to substantial shareholding where gains and losses are excluded from income). The Final Regulations contain other mechanisms permitting taxpayers to preempt or rebut recapture triggering events by submitting evidence of foreign law treatment of losses, but none here.[16]

RECOMMENDATION: We suggest that the Treasury, while retaining the all or nothing rule as the default rule, consider adopting an additional recapture rebuttal procedure permitting the taxpayer to demonstrate, to the satisfaction of the Commissioner, that only a portion of the DCL was used for foreign tax purposes. Procedures similar to those for rebutting a triggering

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[14] Final Regulation §1.1503(d)-6(h).

[15] See Preamble at ¶ O.

[16] See, e.g., Final Regulation §1.1503(d)-6(c) and §1.1503(d)-6(e)(2).

event under Final Regulation §1.1503(d)-6(e)(2) or reducing the presumptive recapture amount under Final Regulation §1.1503(d)-6(h)(2) could be adopted for this purpose. In addition, under the new FIN 48[17] accounting regime, many taxpayers and their financial statement auditors would self-police the correctness of the recapture rebuttal showing. Absent such a mitigating procedure, we are concerned that the all or nothing recapture rule will frequently cause taxpayers to unjustifiably forego the deduction of true economic losses in any jurisdiction.

B. Mirror Legislation

The 1992 DCL Regulations contained a mirror legislation rule. The Preamble states: "The mirror legislation rule was designed to prevent the revenue gain resulting from the disallowance of a double dip from inuring solely to the foreign country."[18] Thus, where a foreign jurisdiction has its own DCL limitation disallowing the use of such dual loss in that jurisdiction, U.S. taxpayers might have (but for the application of the Mirror Legislation rule) made the domestic use election in respect of such loss, confident that foreign law restrictions would assure that there would never be a recapture event because no foreign use was possible. The mirror legislation rule treated the existence of such foreign legislation as giving rise to a deemed foreign use of the particular DCL and thus precluded any domestic use election for such loss. While the underlying purpose of the mirror legislation rule was to stimulate bilateral negotiations between the Treasury and the relevant foreign jurisdiction, the practical impact on a

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17 Financial Accounting Standards Board Interpretation No. 48, *Uncertain Tax Positions* (June 2006).

18 Preamble at ¶ G(5), citing Staff of the Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986, at 1065-1066 (1987). See also See also *British Car Auctions, Inc. v. United States*, 35 Fed. Cl. 123 (1996) *aff'd. without opinion*, 116 F.3rd 1497 (Fed. Cir. 1997) (upholding the validity of the mirror legislation rule).

particular taxpayer was to deny the taxpayer, in both jurisdictions, a deduction for economic costs actually incurred.

Like the 1992 DCL Regulations, the Final Regulations treat the existence of mirror legislation as the "deemed" foreign use of a DCL.[19] To limit this in part, the Final Regulations also include a "stand-alone exception."[20] Under the stand-alone exception, a dual resident unit that has no affiliates in the foreign jurisdiction in the year of the DCL will generally not be subject to the mirror rule. Thus, the stand-alone exception will allow certain taxpayers operating in countries with mirror legislation to avoid the harsh consequences of the mirror legislation rule and instead follow the normal requirements of a domestic use election.

On October 6, 2006, the United States and United Kingdom entered into the US/UK Agreement. Under the US/UK Agreement for mirror losses, the taxpayer is permitted to elect to use certain types of DCLs in either jurisdiction, but not in both. In effect, this puts both jurisdictions in the position of allowing a domestic use election, as is generally available under U.S. law, regardless of the prohibition of foreign use under foreign law. The central principle of the US/UK Agreement, one use of the loss, is consistent with the general approach underlying the DCL rules. Like any treaty agreement, the treaty countries potentially relinquish rights to tax revenue in exchange for tax clarity and the avoidance of double taxation.

Treasury requested specific comments on the effectiveness of the US/UK Agreement. We believe the US/UK Agreement is very effective in resolving the mirror legislation issue identified by it. As we understand it, the U.K. mirror legislation states that a dual resident

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19 See Final Regulation §1.1503(d)-3(e).

20 See Final Regulation §1.1503(d)-3(e)(2).

corporation subject to tax in another jurisdiction may not surrender its losses to offset U.K. income of a group relief affiliate. Thus a U.S. corporation treated as resident in the U.K. because of its management and control in the U.K., would be subject to the U.K. mirror legislation. Because the U.K. adopted rules allowing permanent establishments of foreign corporations to file on a group relief basis with U.K. affiliates, its mirror legislation applies to such branches. The US/UK Agreement does not apply to a dual resident corporation (this was the original situation in *British Car Auctions*). The US/UK Agreement also does not apply to a hybrid entity (that is, an entity treated as a corporation in the U.K. and as transparent in the U.S.), because a hybrid entity is not technically subject to the U.K. mirror rule as it is not subject to tax in another (non-U.K.) jurisdiction. Rather, the agreement applies only to U.K. permanent establishments of U.S. corporations.[21]

The US/UK Agreement provides that it is itself considered an agreement within the meaning of 1992 DCL Regulation §1.1503-2(g)(1) (a "G-1 Agreement"). G-1 Agreements have been continued in Final Regulation §1.1503(d)-6(b) (referred to as, "6(b) Elective Agreements"). Unlike the normal domestic use election, the taxpayer is permitted to make a separate domestic use election pursuant to -6(b) where an agreement exists between the United States and a foreign country that puts into place an elective procedure through which DCLs in a particular year may be used to offset income in only one country. Therefore, while the US/UK Agreement was carefully tailored to respond only to a certain subset of mirror issues, as a 6(b) Elective Agreement, it could have been extended to all DCL situations.

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[21] "The New U.K. – U.S. Agreement", L. Greenwald and J. Rubinger, Tax Notes 841 (Nov. 27, 2006).

Treasury also asked whether the US/UK Agreement should be extended to other jurisdictions.

RECOMMENDATION: We recommend that the 6(b) Elective Agreement regime, modeled after the US/UK Agreement, be extended to all U.S. treaty partners with mirror legislation (e.g., currently the United Kingdom, Australia and Germany are known to have such legislation). This would afford taxpayers with access to elective procedures pursuant to which they could obtain one secure use of their economic loss. Correspondingly, it would affirmatively allow taxpayers to avoid undesirable and inappropriate risks of forfeiture of a deduction attributable to a true economic loss. Furthermore, by allowing the taxpayer to utilize a loss only once but in the jurisdiction of its choice, the agreement avoids the need to resolve U.S. and foreign tax law issues that make the administration of the DCL rules so costly and time consuming.

We believe that 6(b) Elective Agreements are the most promising answer to avoiding the complexities, inconsistencies and forfeitures created by the DCL regime. The mechanic is a simple election enforced by bilateral cooperation. The result, is one secure use of the loss for taxpayers desiring certainty. We therefore further recommend that the structure of the US/UK Agreement be extended not merely to mirror legislation jurisdictions but to all our treaty partners as elective agreements pursuant to Final Regulation §1.1503(d)-6(b). Like all treaty agreements, such a 6(b) Elective Agreement regime could have revenue implications, with the U.S. presumably bearing the greater share because of its often higher rates. However, the revenue consequences to the U.S. may not be greater than those under the normal domestic use election.

C. Reduction of Recapture Amount — SRLY

Upon the occurrence of a triggering event, a taxpayer that has made a domestic use election with respect to a DCL is generally required to recapture the total amount of such DCL in income in the taxable year in which the triggering event occurs. The recapture mechanics in both the Proposed Regulations and Final Regulations allow for the reduction of the recapture amount to the extent the taxpayer can establish, to the satisfaction of the Commissioner, that the DCL would have offset other income of the dual resident corporation or separate unit for intervening taxable periods if the DCL had been subject to the general domestic use limitation rules ("Recapture Reduction Rule").[22] Under this rule, the recapture amount is effectively scaled back to equal the amount of the underlying DCL that would have been carried forward (pursuant to the operation of the domestic use limitation rules) had no domestic use election had been made with respect to such DCL.

Prior to the release of the Final Regulations, the Treasury received comments regarding the appropriate scope of the Recapture Reduction Rule. In particular, commentators noted that, because the domestic use limitation rules import the SRLY regime to effectively quarantine DCLs, a taxpayer's ability to establish that a recaptured DCL would have otherwise offset other taxable income of the dual resident corporation or separate unit would have to take account of the SRLY rules. These commentators suggested that the application of the SRLY rules in the context of the Recapture Reduction Rule could lead to inappropriate results. For example, the SRLY rules would render a recaptured DCL ineligible for reduction under the Recapture Reduction Rule if, during the period in question, the consolidated group in which the DCL was

[22] Regulations §1.1503(d)-6(h)(2)(i).

located had no consolidated taxable income, even if the dual resident corporation or separate unit that generated the DCL had taxable income on a standalone basis during that period.[23] These commentators suggested that the ability of a taxpayer to access the Recapture Reduction Rule should not be prejudiced by the presence or absence of income of other members of the affiliated group. Rather, it was argued, the recapture rule should focus on prevention of double-dips and, to the extent that a dual resident corporation or separate unit generated both loss (the DCL) and income on a standalone basis, there is no offending double-dip. As a result, these commentators argued that the Recapture Reduction Rule should be applied on a separate computational basis, rather than under the SRLY methodology.

Treasury considered but ultimately declined to adopt this recommendation. In the Preamble, Treasury did acknowledge that the policy objectives underlying the SRLY rules and the Final Regulations are not in complete harmony, but took the view that the SRLY methodology would be reasonable and appropriate in the vast majority of cases. While Treasury indicated that deviation from the SRLY methodology would likely result in additional complexity that, in turn, might result in unintended consequences, it did undertake to consider addressing the interaction of the SRLY rules with the recapture provisions of the Final Regulations in future guidance. Comments were requested regarding alternative mechanisms that are more consistent with DCL policy and that are not unduly complicated.

We believe that it is appropriate, in certain cases, to modify the operation of the SRLY rules in the context of the Recapture Reduction Rule. First, if a dual resident is required to recapture a prior DCL, it is not at all clear, from a policy perspective, why the DCL regime

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[23] The focal point of these comments appear to be Example 52 of the Proposed Regulations. A similar illustration is included in Example 40 of the Final Regulations.

should require that taxpayer to recapture more loss than it actually accumulated on a stand-alone basis. Second, the posture of a taxpayer that is confronted with DCL recapture will often be significantly different from the posture of a taxpayer that, from the outset, chose to be subject to the domestic use limitation rules of Final Regulation §1.1503(d)-4 and, in many cases, it is not appropriate to treat these two constituencies identically. In particular, a taxpayer that has affirmatively chosen to be subject to the domestic use limitation rules can, and presumably will, take steps to utilize the full amount of the subject DCL for foreign tax purposes and, as a result, it is appropriate to fully isolate this DCL for U.S. tax purposes through the mechanics of the SRLY rules. On the other hand, a taxpayer that is required to recapture the total amount of DCL subject to a domestic use election may not have the ability to fully utilize the subject DCL for foreign tax purposes (and in some cases, only a small portion of the DCL may be put to foreign use). In this context, we anticipate scenarios in which taxpayers will experience hardship.

RECOMMENDATION: Accordingly, we recommend that the IRS establish a Revenue Procedure pursuant to which taxpayers that are required to recapture a DCL because of foreign use will be eligible for the Recapture Reduction Rule in accordance with the general rules of Final Regulation §1.1503(d)-4 without regard to SRLY methodology. The DCL would be recaptured but reduced by the other income of the dual resident corporation or separate unit, determined on a stand alone basis, and without regard to the consolidated income or loss of the taxpayer's consolidated group.

D. Foreign Use

The mechanics of the DCL Regulations rely heavily upon the concept of foreign use of losses. It is the foreign use of losses which prevents making a domestic use election or requires recapture of losses previously subject to a domestic use election. If the taxpayer can demonstrate

to the satisfaction of the Commissioner that there is no possibility of foreign use, the loss is excepted from the SRLY limitation normally imposed on DCLs.[24] Under the 1992 DCL Regulations and also in the Final Regulations, a loss of a dual resident unit, as calculated under U.S. rules, is treated as having been subject to foreign use when any portion of the DCL is made available under foreign law to reduce directly or indirectly any item of income of a foreign person[25]. The fact that the existence of the loss is calculated under U.S. principles, but the loss is deemed used when made available under foreign law, highlights the tension in the DCL rules between the use of U.S. law and foreign law. Generally, the DCL rules attempt to use foreign law only as necessary to establish that the loss has been made available to a foreign affiliate.

The Final Regulations make a concerted attempt to restrict the scope of the foreign use definition. In particular, they create new safe harbors: (i) for certain situations posing only a de minimis risk of actual foreign use,[26] and (ii) for transactions giving rise to foreign use that are outside the taxpayer's control.[27] Additional safe harbors may be added by published guidance[28]. Furthermore, if a taxpayer is able to demonstrate that there is no possibility of foreign use of the DCL, it is excepted from the basic SRLY limitation.[29]

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24 See Final Regulation §1.1503(d)-6(c).

25 See Final Regulation §1.1503(d)-3(a)(1).

26 See, e.g., Final Regulation §1.1503(d)-3(c)(5) (relating to less than a 10% reduction in ownership in a separate unit over a 12-month period and less than a 30% reduction at any time) and -3(c)(6) (relating to taxable asset sales of less than 10% of assets of a dual resident corporation or separate unit over a 12-month period and less than 30% of such assets at any time). We read these *de minimis* rules as being applied on an aggregate basis to one or more units treated as a combined separate unit under Regulation §1.1503(d) -1(b)(4), rather than on a separate unit by separate unit basis. Clarification of this interpretation would, however, be welcomed.

27 See, e.g., Final Regulation §1.1503(d)-6(f)(5).

28 See Final Regulation §1.1503(d)-3(c)(9).

29 See Final Regulation § 1.1503(d)-6(c).

Despite these limiting safe harbors, the scope of foreign use is significantly broadened by the concept of indirect foreign use.[30] This expansion is especially important given that the relevant safe harbors appear to be designed to relate primarily to direct foreign use rather than indirect foreign use. While one prior private letter rule interpreted indirect foreign use broadly,[31] the Preamble states that indirect foreign use should apply not to ordinary business transactions, but only to transaction structures where the taxpayer is deliberately intending to transfer items of loss to achieve a double-dip. Under Final Regulation §1.1503(d)-3(a)(2), indirect foreign use is considered to occur if: (i) one or more items are taken into account as deductions or losses for foreign tax purposes, but do not give rise to corresponding income or gain for U.S. tax purposes, and (ii) such foreign law deduction has the effect of making all or part of a DCL available for foreign use. An exception to this rule, for transactions in the ordinary course of business not incurred for the principal purpose of avoiding the DCL limitations, is not available where inconsistent treatment of entities or items exist. Under this definition, indirect foreign use is effectively presumed if the U.S. treatment and foreign law treatment of an item of interest is inconsistent.[32]

The broadening of foreign use through the concept of indirect foreign use can be seen in the alternative facts contained in Example 6,[33] depicted in Annex D hereto. In that example, P (a U.S. corporation) owns 100% of a foreign (Country Y) disregarded entity (DE3y). A third party

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30 See Regulation §1.1503(d)-3(a)(2).

31 See Field Service Advice 200221018 (Feb. 13, 2002) (stating that, because foreign use included use "by any means", it was extremely difficult to dispute).

32 See Final Regulation §1.1503(d)-3(a)(2) and §1.1503(d)-7(c), Examples 6, 7 and 8.

33 See Final Regulation §1.1503(d)-7(c).

bank lends money to DE3y and DE3y on-loans the proceeds of this loan to its foreign (Country X) wholly owned disregarded subsidiary (DE1x). DE1x owns 99% of a company treated as a partnership under local law but a corporation for U.S. purposes (FRHx). DE1x pays interest to DE3y and uses the deduction under local law to offset its allocable share of income from FRHx.

For DCL purposes, the foregoing example is analyzed as giving rise to an indirect foreign use. For this purpose, DE3y and DE1x are not combined because they are in different countries. But the loan and interest on the loan between DE3y and DE1x are disregarded for U.S. tax purposes. As a result, DE3y has a loss on its bank interest expense without offsetting income. This creates a DCL but no foreign use. DE1x has no loss under U.S. tax principles since its interest expense to DE3y is disregarded. Nonetheless, the Example concludes that there has been an indirect foreign use of DE3y's loss because interest on the disregarded loan (a) gives rise to an item of deduction under Country X law but does not generate any corresponding item of income as determined for U.S. tax purposes, and (b) has the effect of making an item of deduction composing the DCL available for foreign use. Accordingly, DE3y's loss is subject to SRLY limitations without any possibility of a domestic use election. In this example, indirect foreign use analysis amounts to an examination of the foreign law treatment of the transactions without regard to the domestic consequences of the U.S. check-the-box rules. It should not be surprising that our check-the-box regime produces the kinds of inconsistencies that can readily give rise to indirect foreign use.[34]

We question whether inconsistent treatment of tax items, coupled with the somewhat unclear requirement in Final Regulation §1.1503(d)-3(a)(2)(i)(B) that turns on the "effect" of the

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34 See also Final Regulation §1.1503(d)-7(c), Example 8.

arrangement, can be an appropriate filter for identifying transactions exhibiting double-dip opportunities. Inconsistent treatment is inherent in the DCL area because we apply U.S. domestic tax law principles for income recognition to units operating in foreign countries. As a result, the U.S. rules for substance over form (e.g., treating repurchase obligations as secured loans) and item recognition (e.g., disregarding branch/parent transactions), which in many cases will have no analog under foreign law, will often create the requisite inconsistency. In the absence of clear guidance regarding the "effect" based requirement of Final Regulation §1.1503(d)-3(a)(2)(i)(B), indirect foreign use can be reliably disproved only by affirmatively establishing the foreign law treatment of items. Thus, it may be that no domestic use election is fully established without an opinion on foreign law. We question whether this approach is consistent with Treasury's stated intention of reducing complexity and facilitating the administrability of the DCL regime.

RECOMMENDATION: We recommend that indirect foreign use not be based upon inconsistent treatment. Rather, we think indirect foreign use should be based upon transactions lacking a substantial non-U.S. tax business purpose that have the effect of making items of loss available for foreign use. Alternatively, a safe harbor should be created for taxpayers able to certify that a specified transaction was engaged in on an arm's length basis in the ordinary course of business and supported by a substantial non-tax business purpose. See Section III.B below.

E. Attribution of Items

Since 1988, when the DCL limitations were extended to units of domestic corporations, questions have lurked as to which items of income and loss should be attributed to the unit. The 1992 DCL Regulations specify that the separate unit must compute its income "as if it was a separate domestic corporation ... using only those items of income and loss that are otherwise

attributable to such separate unit".[35] For this purpose, items are only attributed to the extent that they are recognized for U.S. tax purposes. For example, a loan by a U.S. corporation to its foreign branch would not be regarded as a loan for U.S. tax purposes, and interest on such branch loan would not be attributed to the branch.

A problem with attribution rules arises under foreign law when one compares attribution to a hybrid entity and attribution to a natural branch. For example, a private foreign company that is wholly owned by a U.S. corporation and disregarded for U.S. tax purposes under a check-the-box election, would be regarded as a branch for U.S. purposes. However, such company would be a fully taxable corporation for foreign law purposes. Accordingly, such foreign company would maintain its separate statutory books and records and local income tax filing records. By comparison, where a U.S. corporation operates in a foreign jurisdiction through a natural branch, the branch will also be subject to taxation in the foreign jurisdiction but may not have separate accounting statements or income tax books. The branch may file foreign income tax returns under an allocation method or some foreign law attribution arrangement.

The Final Regulations follow the Proposed Regulations in using different attribution methodologies for hybrid units and for natural branches. Hybrid entities are attributed items based upon their books and records.[36] The attribution of book items applies in the DCL context "as adjusted to conform to U.S. tax principles". We assume these adjustments would include adjustments to reflect that certain items are disregarded under U.S. tax principles (e.g.,

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35 1992 DCL Regulations §1.1503-2 (d)(1)(ii).

36 See generally Final Regulation §1.1503(d)-5(c)(3).

disregarding branch loans from the head office) as well as adjustments to adopt arm's-length standards for related company transactions.

By contrast, a natural branch is required to allocate expenses under the principles of Section 864(c)(2), (4) and (5) regarding the asset use test and material factor test and as set forth in Treasury Regulations §1.864-4(c) and §§ 1.864-5 through 7.[37] Interest expense for the natural branch is allocated in accordance with the allocation principles in Treasury Regulation §1.882-5. Under the Final Regulations, the attribution rules for the interest expense of natural branches are superseded by the books and records approach where a taxpayer shows that the applicable foreign country attributes interest expense to the branch solely by reference to books and records.[38] Treasury's rationale for this difference in approach between natural branches and hybrid entities is that foreign law would generally recognize the hybrid unit's own books and records for tax filings but would not recognize the books of a foreign natural branch.[39]

The distinction in the DCL rules between natural branches and hybrid units that are treated as disregarded entities is difficult to justify under U.S. tax principles. Some would assume that the rule for hybrid units' books and records, as adjusted for U.S. tax principles, would include U.S. rules for item recognition and arm's length adjustments. The allocation rules under Treasury Regulation §1.882-5 for interest expense of foreign corporations are designed to simplify the establishment of arm's-length allocation of interest expense. These rules should be

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37 See generally Final Regulation §1.1503(d)-5(c)(2).

38 See Final Regulation §1.1503(d)-5(c)(2)(iii).

39 See preamble to the Proposed Regulations.

harmonized for DCL purposes. The adoption of different attribution mechanics for similarly situated entities is somewhat awkward.

RECOMMENDATION: We recommend that the methodology for the attribution of items to separate units in the Final Regulations be made consistent as to both natural branches and hybrid units. We believe that the Section 987 principles, adopted in Final Regulations §1.1503(d)-5(c)(3), of attributing items to hybrid units in accordance with local books and records, as adjusted for U.S. principles, is appropriate under the DCL rules, and we suggest that the same methodology be required for attributing items to natural branches. In both cases, in contrast to Final Regulation §1.1503(d)-5(c)(2)(ii), interest expense of the separate unit's Parent would not be attributed to the natural branch or hybrid unit under the principles of Treasury Regulation §1.882-5, except to the extent that, in accordance with Final Regulation §1.1503(d)-5(c)(2)(iii), local law looks beyond the branch books and records and attributes interest expense on another method.

F. <u>Consistent Treatment of Economically Equivalent Transactions</u>

The Final Regulations contain a series of examples which greatly clarify the application of the new rules to hybrid entities and branches. However, because of distinctions in the rules with respect to disregarded entities and natural branches, disregarded items and regarded items, as well as divergent methodologies for the attribution of income to hybrid entities and natural branches, these examples can also illustrate the potential for the DCL rules to reach inconsistent results in situations where, arguably, they should not. In particular, we had difficulty with the apparent inconsistency between the result reached in Example 23 with the result that would be reached in scenarios that are economically similar.

Example 23 of the Final Regulations, depicted in Annex A, describes a well known device for avoiding the DCL limitations (i.e., the parent/disregarded entity loan ("Parent/DRE loan")). In the Example, a U.S. parent corporation ("Parent") borrows from a third party bank ("Bank Loan") and on-lends the proceeds to its wholly-owned foreign subsidiary which is a disregarded entity for U.S. tax purposes ("DRE"). The Example concludes that, although DRE does constitute a hybrid entity separate unit of Parent, no amount of DRE's interest expense to Parent or the interest expense on the third party Bank Loan is attributed to DRE under Final Regulation §1.1503(d)-5(c)(3). This is because loans from a corporation to its own branch or disregarded entity are not regarded as loans for U.S. tax purposes and accordingly are not items regarded for DCL computation purposes. Since hybrid entity separate unit interest deductions are determined by the branch's books and records method as adjusted for U.S. tax principles and the interest expense related to Parent's bank loan is not reflected on the local law books and records of DRE, there is no DCL attributable to Parent's interest in DRE. Accordingly, the Example concludes that there is no DCL limitation applicable.

The conclusion expressed in the Parent/DRE loan Example, standing on its own, is consistent with the prevailing view of practitioners. The Parent/DRE loan was specifically described in the 2005 NYSBA Report as an example of inconsistent treatment. That Report did not say that this result for the Parent/DRE loan was necessarily wrong. For example, the conclusion that the Parent/DRE loan creates no DCL may have fairly implemented the Congressional intent that Section 1503(d) should not be read as intending to restrict the deduction of U.S. parent company's interest expense.

In contrast to Example 23, however, it is illustrative to consider precisely the same facts but, in lieu of parent on-lending to a hybrid entity separate unit, the on-loan is made to a natural

branch separate unit ("Branch"), depicted in Annex B ("Parent/Natural Branch Loan"). In this Parent/Natural Branch Loan, the analysis with respect to the attribution of Parent's interest expense diverges from the analysis that applies in Example 23. In this iteration, Parent's interest expense on the third party loan would be attributed to Branch pursuant to Final Regulation §1.1503(d)-5(c)(2)(ii), which incorporates the interest allocation methodology described in Treasury Regulation §1.882-5. Under this approach, some portion of P's interest expense will be allocated to Branch under the asset based apportionment methodology. As a result, Branch will be treated as having a regarded interest expense and, in turn, a loss that it may potentially utilize to offset the income of its foreign subsidiary (assuming that local laws permit branches and subsidiaries to consolidate, as many jurisdictions do). Thus, the result in Example 23 is reversed merely by substituting a natural branch for a disregarded entity. The difference in result may appear reasonable within the logical construct of the Final Regulations designed to mechanically identify double-dipping. In the broader context, however, this distinction between two economically identical transactions is questionable.[40] For taxpayers with flexibility, it renders the application of the DCL rules elective; for taxpayers legally required to operate through a branch, it renders the rule discriminatory.

A similar inconsistency appears when one compares Example 23 (the Parent/DRE loan) to Example 6 (Bank/DRE loan). In Example 6, depicted in Annex C, a U.S. parent ("P") owns 100% of a disregarded entity in country X (DREx). DREx owns 99% of a Country X entity that is treated as a flow-through entity for Country X purposes and a corporation for U.S. tax

[40] The check-the-box rules strongly imply that entities disregarded thereunder are disregarded for federal tax purposes (see Treasury Regulation §301.7701-3(a) and (b)). To impose a different rule for DCL purposes on a disregarded entity than that applied to a natural branch is inconsistent with this principle.

purposes (a foreign reverse hybrid ("FRH")). A wholly-owned corporate subsidiary of P ("S") owns the remaining 1% interest in FRH. DREx borrows from a bank, presumably to buy the interests in FRH. DREx's interest expense in country X offsets income which flows up to it for Country X tax purposes from FRH. In this situation, the Example concludes that interest expense owed by DREx gives rise to a DCL and that this DCL has been used directly to offset the income of another foreign person, the FRH, which the U.S. regards as a foreign corporation. Therefore, the DCL limitations apply and all the usual DCL consequences of foreign use flow from this. In contrast to this Example 6, where the third-party borrowing by DREx results in DCL limitations, no DCL results in Example 23 when P borrowed from a third-party and then on-loaned the proceeds to DRE.[41] Thus, even though the disregarded entity is treated as part of its parent under the check-the-box rules, its separate existence is taken into account for DCL purposes, and the determination of whether it borrows directly from the bank or from its parent has material consequences for DCL purposes.

We believe that the result reached in Example 23 should be changed. The members of our Executive Committee have different views, however, regarding the appropriate mechanic to remedy the Example. Some members are of the view that the application of the books and records attribution approach for hybrid entity separate units is inappropriate in cases where the U.S. affiliate acts as a financing conduit and that, in such cases, the general interest attribution

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[41] We also note that, in the alternative Example contained in Example 6, depicted in Annex D hereto, the intercompany loan between DE1x and DE3y (which was a disregarded loan for U.S. tax purposes) was the medium through which the Example identified indirect foreign use (i.e., this disregarded intercompany loan "has the effect of making an item of deduction or loss composing the dual consolidated loss attributable to P's interest in DE3y available for a foreign use"). We question the congruity of a regime which takes cognizance of disregarded items for some purposes (e.g., identifying indirect foreign use) but not for others (e.g., the parent/disregarded entity loan in Example 23 is not recognized for purposes of determining whether there is a DCL attributable to P's interest in DRE).

methodology of Treasury Regulation §1.882-5 should apply. Others feel that it is inappropriate, in the context of Example 23, to disregard the existence of the loan between P and DRE for purposes of determining the existence of a DCL attributable to DRE. If, for DCL purposes, the DRE is regarded as a subsidiary, shouldn't loans from the parent be regarded as they would normally be for loans to a regarded subsidiary? While the means of resolving the problem we see with Example 23 are subject to debate, we note that the underlying incongruities (as illustrated above) that Example 23 appears to sanction are troubling. We are concerned that these incongruities create an electivity in the DCL regime that may be exploited. As a result, we believe the Treasury should reconsider Example 23.

III. OTHER REQUESTED COMMENTS

A. Exceptions to Foreign Use

The Final Regulations contain safe harbors within which foreign use will not be deemed to occur. The Treasury has requested comments on additional transactions suitable for safe harbor treatment.

With respect to matters of direct foreign use, we believe that the safe harbors in the Final Regulations, together with the illustrative examples, provide reasonable guidance regarding this issue and, accordingly, we do not have substantive recommendations in this regard at this time. However, because of the complex and evolving factual situations in which questions of direct foreign use arise (or will arise) and the continuing central role of this concept to the operation of the Final Regulations, we recommend that the IRS issue a Revenue Procedure, pursuant to the authority granted by Final Regulation §1.1503(d)-3(c)(9), establishing procedures by which taxpayers can obtain expedited guidance regarding the issue of foreign use in circumstances where the Final Regulations do not provide clear direction.

B. Indirect Foreign Use

Treasury's request for comments regarding additional foreign use safe harbors did not specifically solicit comments regarding indirect foreign use. However, we believe that additional guidance that is specifically focused on the concept of indirect foreign use would be extremely helpful. In particular, although the expansion of foreign use safe harbor protection under Final Regulation §1.1503(d)-3(c)(2)-(8) is certainly welcome, each of these safe harbors appears to primarily target issues of direct foreign use, not indirect foreign use. In some cases, it is not clear how these safe harbors would operate in the context of indirect foreign use, and in other cases they may even be incompatible with the concept of indirect foreign use.

For example, the safe harbor in Final Regulation §1.1503(d)-3(c)(2) provides in part that if the laws of a foreign country provide an election that would enable a foreign use, such foreign use is considered to occur only if the election is made. This safe harbor does not distinguish between direct and indirect foreign use, and it is not clear whether a taxpayer that does not make such an election is entitled to assert the safe harbor protection of this provision if there is concurrently or subsequently indirect foreign use. While the impact of elections available under foreign law on direct foreign use may be identified with reasonable certainty, it is less obvious whether the decision to make (or not make) such an election has any discernable causal link to a finding of indirect foreign use. Consequently, the scope of the protection afforded by Final Regulation §1.1503(d)-3(c)(2) is uncertain. Indeed, in the absence of safe harbors focused specifically on indirect foreign use, the spectre of indirect foreign use may undermine the protection that each of the foreign use safe harbors is intended to provide.

The indirect foreign use rules do provide self-contained exceptions to indirect foreign use.[42] However, procedurally these exceptions operate as a rebuttal mechanism (requiring the taxpayer to establish the applicability of an exception to the satisfaction of the Commissioner) after there has been a preliminary finding of indirect foreign use. While these exceptions are certainly helpful as a reactive measure and assist in delineating the appropriate scope of the indirect foreign use rules, there is no clear proactive safe-harbor guidance to assist taxpayers in obtaining comfort that they are not engaging in prohibited indirect foreign use in the first place.

RECOMMENDATION: We recommend that the IRS promulgate additional guidance, pursuant to the authority granted in Final Regulation §1.1503(d)-3(c)(9), regarding indirect foreign use. Given the expansive reach of the indirect foreign use concept, it may be advisable for this guidance to be provided in several forms. First, we recommend that Treasury issue a Revenue Procedure establishing additional safe harbors specifically addressing indirect foreign use. In particular, this Revenue Procedure may provide safe harbor protection in the following circumstances: (a) no indirect foreign use unless the amount of such use exceeds a specified *de minimis* amount (this safe-harbor would provide significant protection against inadvertent indirect foreign use); and (b) no indirect foreign use if the taxpayer certifies that a particular transaction is engaged in on an arm's length basis in the ordinary course of its business and such transaction is supported by a substantial non-U.S. tax business purpose. The latter safe harbor would effectively elevate the principal purpose rebuttal mechanism contained in Final Regulation §1.1503(d)-3(a)(2)(ii) to the status of an affirmative requirement for safe harbor protection from indirect foreign use. We believe that this is appropriate, particularly if the

42 See Final Regulation §1.1503(d)-3(a)(2)(ii).

taxpayer specifically identifies the subject transaction in a certification to the IRS. Second, we recommend that Treasury provide guidance in the form of published rulings illustrating which types of transactions have the "effect of making an item of deduction or loss composing the dual consolidated loss available for a foreign use."[43] Greater clarity in this area would assuage justifiable concerns that taxpayers may inadvertently engage in indirect foreign use.

C. Reasonable Cause Exception

During the pendancy of the proposed regulations, the IRS released Notice 2006-13 to introduce a reasonable cause exception for late filing of elections under the 1992 DCL Regulations.[44] Historically, late filing of elections or certifications under the 1992 DCL Regulations required application to the IRS National Office for 9100 relief, under Treasury Regulation §301.9100. We understand that in the context of late filings under the 1992 DCL Regulations, the Service routinely granted relaxations of the time deadlines to permit taxpayers to correct missed or omitted filings. The complexity of the DCL regime and the lack of taxpayer awareness of its application justified the liberal 9100 relief practice.

The Proposed Regulations suggested that, rather than relying on 9100 relief, it would be more effective for a taxpayer to apply to the Director of Field Operations overseeing its tax return for relief from these delinquencies where the taxpayer could demonstrate reasonable cause. Notice 2006-13 sets forth procedures for the reasonable cause filings. It provides, among other things, that the taxpayer may treat its late filing as timely if it can demonstrate to the Director of Field Operations that the taxpayer's failure was due to reasonable cause and not

[43] See Final Regulation §1.1503(d)-3(a)(2)(i)(B).

[44] 2006-8 IRB 496 (January 31, 2006).

willful neglect. The taxpayer would need to file all required documents with an amended income tax return once it became aware of its failure to meet the filing deadline. Under the notice, the Director would notify the taxpayer within 120 days if the failure was considered to be reasonable or if additional time was necessary for the Director to reach a conclusion on this issue.

The Final Regulations adopt the reasonable cause exception application as the exclusive basis for relaxation of the required filing deadlines.[45] This raises two concerns. First, the reasonable cause exception might not be administered as consistently or as generously by the Director of Field Operations as by the National Office which had previously reviewed 9100 relief application. In this regard, the reasonable cause procedure is currently utilized for curing late filings under Sections 367 and 6038B, suggesting that regional administration can be satisfactory. The second concern is that the Director of Field Operation office may frequently extend the 120 day time period, leaving unresolved the tax exposure associated with a late filing. Because the magnitude of the DCL at issue will in many cases be considerable, any delayed resolution of the reasonable cause application could result in a material item carried on the taxpayer's financial statements.

While we believe the procedure set forth in Notice 2006-13 is appropriate, we urge the IRS to monitor the procedure carefully to see that taxpayer requests for late filing relief are resolved in a manner consistent with past practices.

D. Effective Dates

The effective dates of the Final Regulations were of high importance to the many taxpayers who had struggled to interpret the provisions of the 1992 DCL Regulations. The 2005

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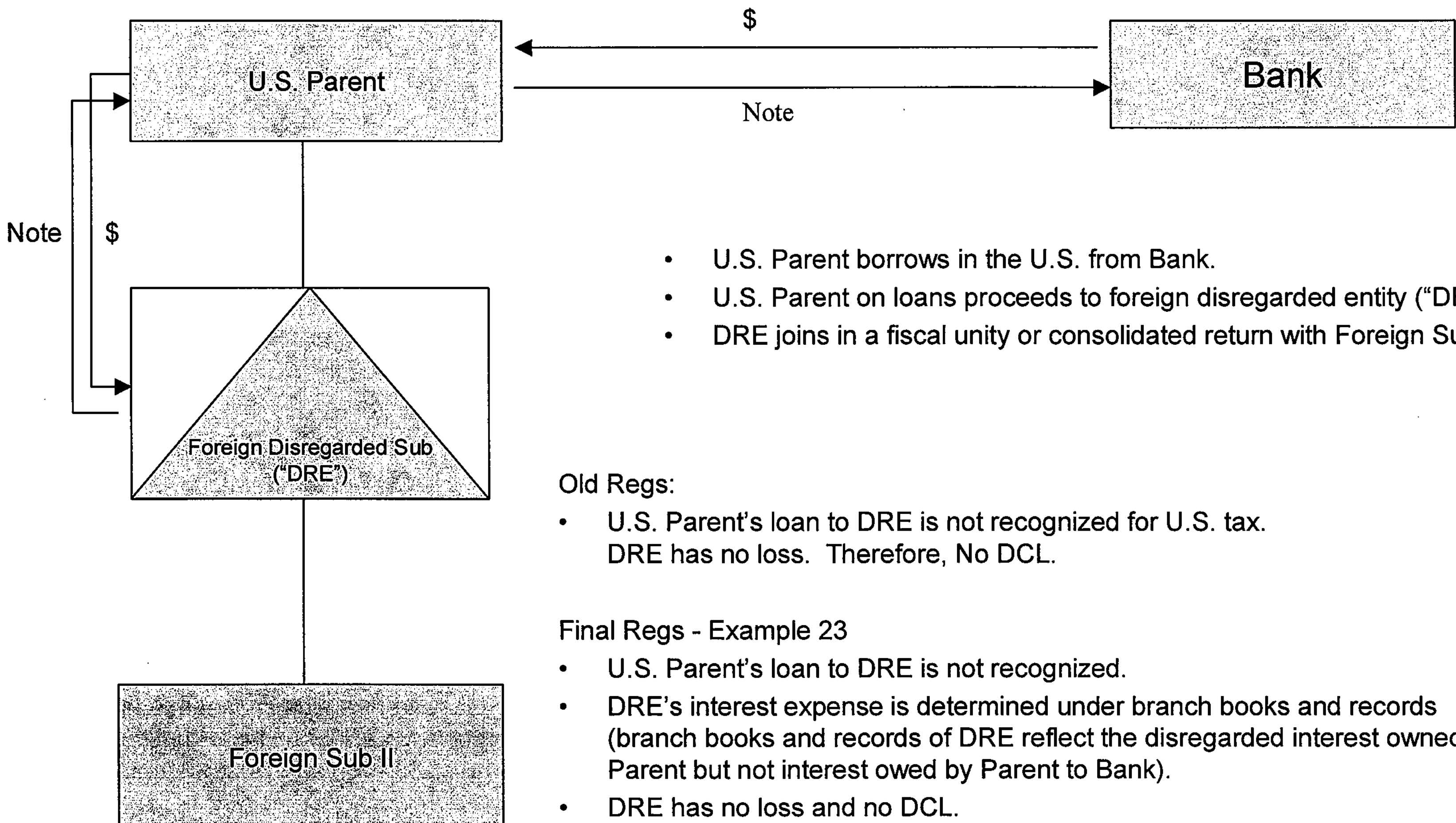
45 See Final Regulation §1.1503(3)-1(c).

NYSBA Report recommended that taxpayers be permitted to apply the Final Regulations for all open years, since the Final Regulations have resolved many prior issues. The Treasury did not adopt that recommendation. Instead, the Final Regulations are effective for taxable years beginning after April 18, 2007. Taxpayers may apply the Final Regulations in their entirety for losses incurred in years beginning on or after January 1, 2007 but, except as provided below, not to prior years.

Notwithstanding these general effective dates, the Certification Periods for domestic use elections filed under the 1992 DCL Regulations will be truncated. Thus, Certification Periods overlapping the new effective dates of the Final Regulations will end after the fifth year of certification. The reasonable cause exception also goes into effect for late filings under prior law. Perhaps most importantly, the elimination in the Final Regulations of the former special basis adjustment rules for stock or interests in dual resident units will apply to all taxpayers to the extent such basis is relevant in an open taxable year.

The decision of the Treasury to make the Final Regulations generally effective for purposes of determining the applicable Certification Periods, the reasonable cause exception, and the basis adjustment, is commendable. We hope that, as a practical matter, audit issues from prior years subject to the 1992 DCL Regulations (particularly issues that are more fully addressed in the Final Regulations than they were in the 1992 DCL Regulations) will tend to be resolved by reference to the Final DCL Regulations.

Annex A
Example 23 - Parent/DRE Loan



- U.S. Parent borrows in the U.S. from Bank.
- U.S. Parent on loans proceeds to foreign disregarded entity ("DRE").
- DRE joins in a fiscal unity or consolidated return with Foreign Sub II.

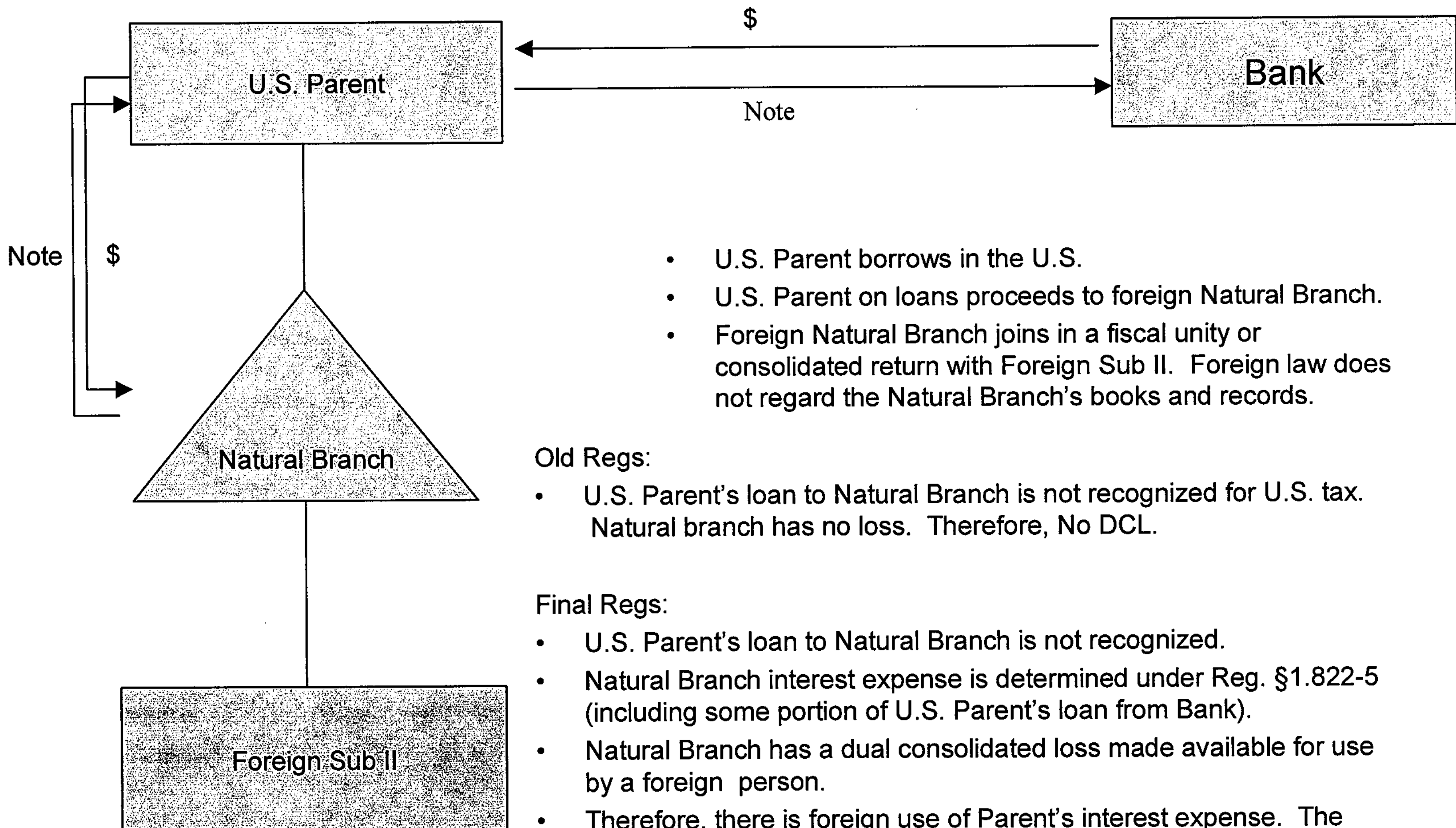
Old Regs:

- U.S. Parent's loan to DRE is not recognized for U.S. tax.
  DRE has no loss. Therefore, No DCL.

Final Regs - Example 23

- U.S. Parent's loan to DRE is not recognized.
- DRE's interest expense is determined under branch books and records (branch books and records of DRE reflect the disregarded interest owned to Parent but not interest owed by Parent to Bank).
- DRE has no loss and no DCL.

Annex B
Parent/Natural Branch Loan



- U.S. Parent borrows in the U.S.
- U.S. Parent on loans proceeds to foreign Natural Branch.
- Foreign Natural Branch joins in a fiscal unity or consolidated return with Foreign Sub II. Foreign law does not regard the Natural Branch's books and records.

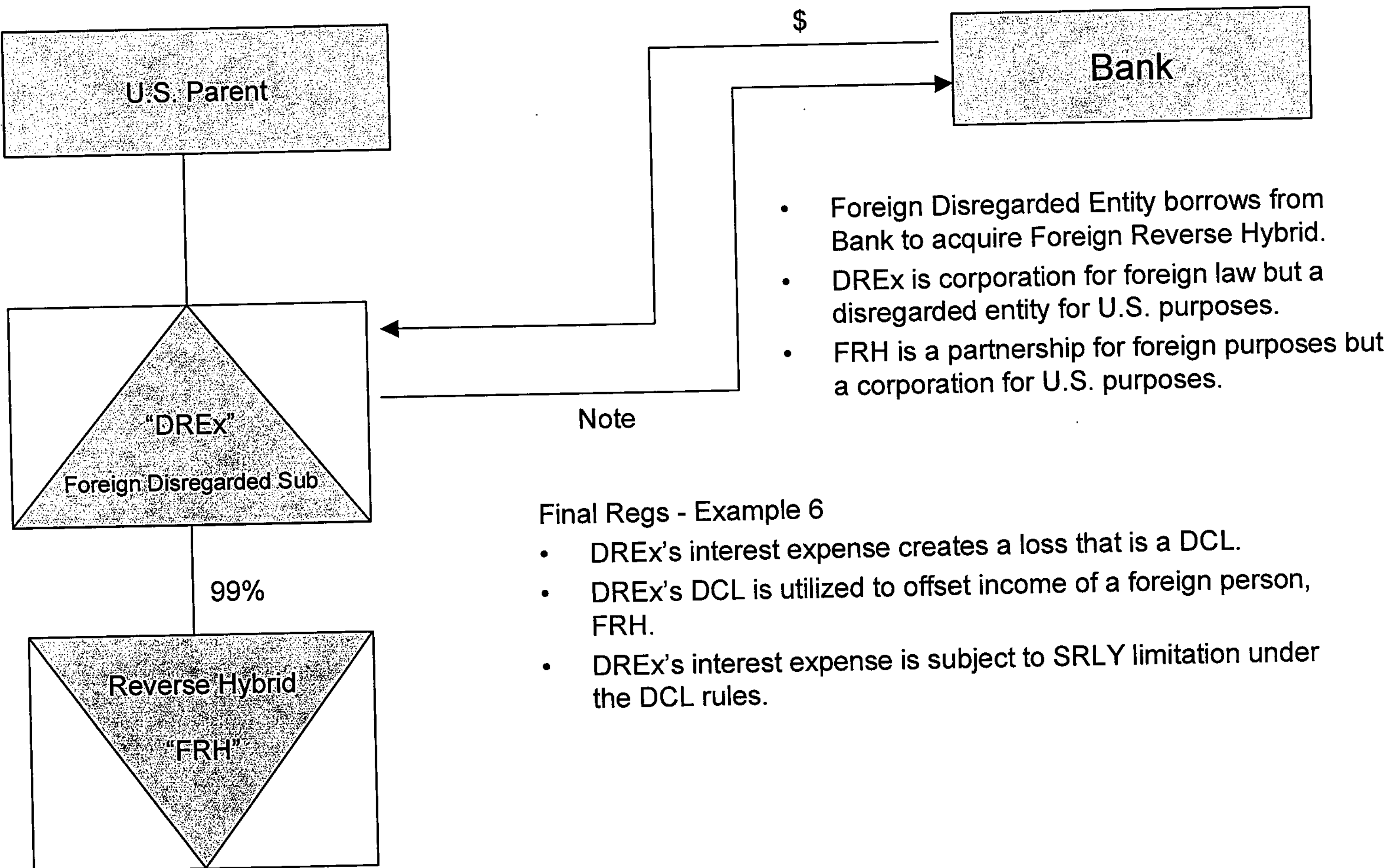
Old Regs:

- U.S. Parent's loan to Natural Branch is not recognized for U.S. tax. Natural branch has no loss. Therefore, No DCL.

Final Regs:

- U.S. Parent's loan to Natural Branch is not recognized.
- Natural Branch interest expense is determined under Reg. §1.822-5 (including some portion of U.S. Parent's loan from Bank).
- Natural Branch has a dual consolidated loss made available for use by a foreign person.
- Therefore, there is foreign use of Parent's interest expense. The DCL Natural Branch is subject to SRLY limitations pursuant to Final Regulation §1.1503(d)-4.

Annex C
Example 6 - Bank/DRE Loan

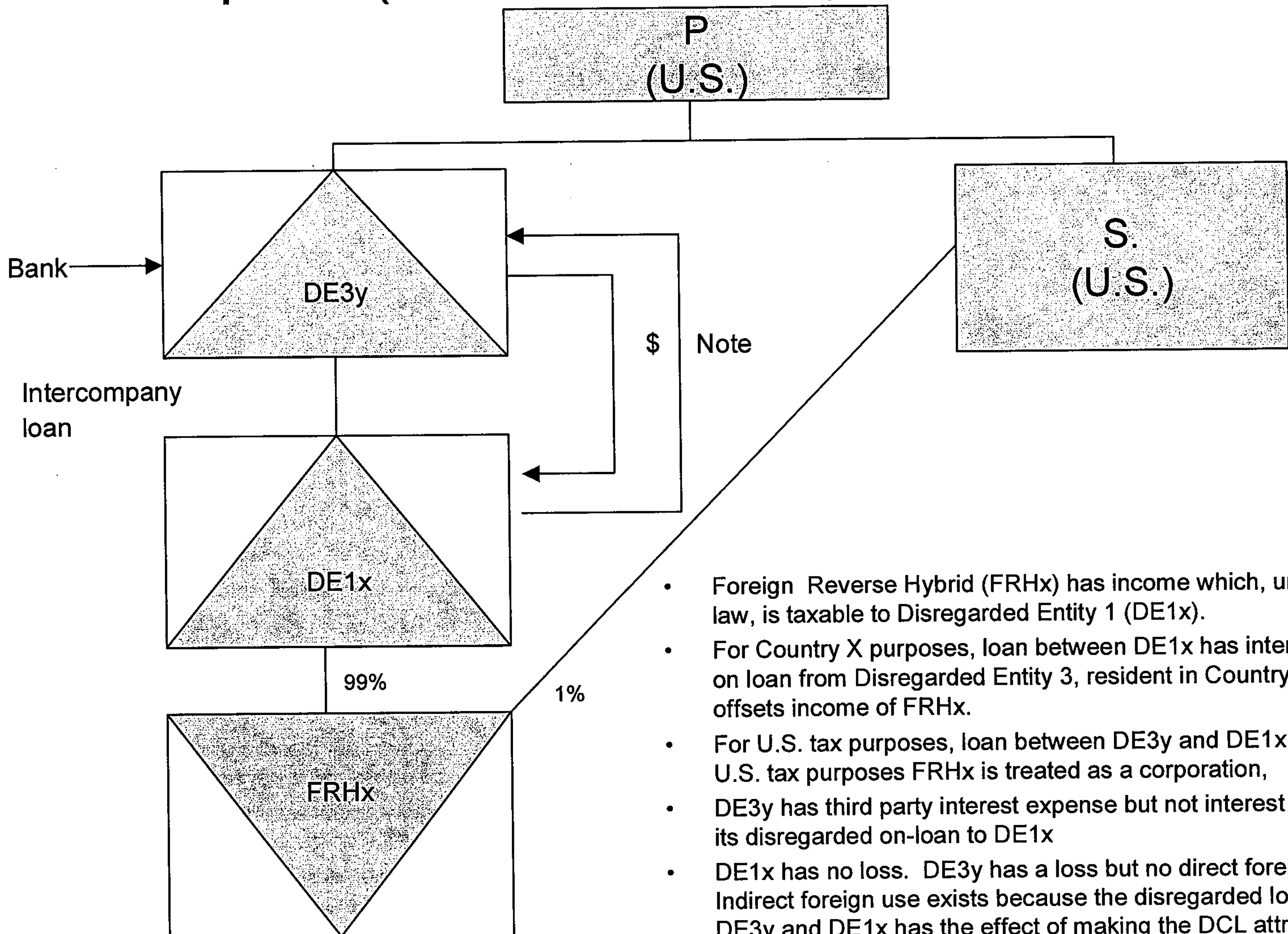


- Foreign Disregarded Entity borrows from Bank to acquire Foreign Reverse Hybrid.
- DREx is corporation for foreign law but a disregarded entity for U.S. purposes.
- FRH is a partnership for foreign purposes but a corporation for U.S. purposes.

Final Regs - Example 6

- DREx's interest expense creates a loss that is a DCL.
- DREx's DCL is utilized to offset income of a foreign person, FRH.
- DREx's interest expense is subject to SRLY limitation under the DCL rules.

Annex D
Example 6 (alternative facts) - Bank/DRE Loan



- Foreign Reverse Hybrid (FRHx) has income which, under Country X law, is taxable to Disregarded Entity 1 (DE1x).
- For Country X purposes, loan between DE1x has interest expense on loan from Disregarded Entity 3, resident in Country Y (DE3y), that offsets income of FRHx.
- For U.S. tax purposes, loan between DE3y and DE1x is ignored. For U.S. tax purposes FRHx is treated as a corporation,
- DE3y has third party interest expense but not interest income from its disregarded on-loan to DE1x
- DE1x has no loss. DE3y has a loss but no direct foreign use. Indirect foreign use exists because the disregarded loan between DE3y and DE1x has the effect of making the DCL attributable to P's interest in DE3y available for foreign use by DE1x.